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NSC FOR KURT TONG

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SUBJECT: GOLDMAN SACH'S GAOHUA SECURITIES: AN ONLY CHILD

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¶1. (SBU) Summary: Goldman Sachs' venture in China, Gaohua Securities, has both benefited and suffered from being the only foreign-controlled, full service securities firm in China. Goldman's method of obtaining control of a Chinese licensed securities firm by giving unsecured loans to trusted Chinese business partners was, likely, "not a replicable model, said Gaohua Securities Company's Executive Director in a meeting with visiting Finatt on May 16. In addition to explicit rules barring foreign from having majority ownership in Chinese securities firms, there are also more subtle barriers such as onerous licensing examinations for senior managers. Goldman Sachs looked forward to the day when other foreign securities firms were doing business in China since securities market liberalization would not been viewed by the Chinese as having benefited a single firm. End summary.

¶2. (SBU) In a meeting on May 16, Gaohua Securities Company Executive Director Raymond Yin told visiting Embassy Finatt that the Goldman Sachs-Gaohua model for establishing a foreign-operated, but wholly Chinese-owned full service securities firm was most likely "not a replicable model." Goldman worked out a deal by which it provided two Chinese individuals with ties to the banking industry with unsecured loans to cover seventy-five percent of its start-up fees. The venture capital subsidiary of the Lenovo computer company anteed up the remaining twenty-five percent to start the Gaohua Securities Company. Goldman and Gaohua then set up the Gaohua-Goldman Sachs Banking joint venture in which Goldman has a 33 percent equity stake, but like other foreign owned joint ventures, is not allowed to trade A shares either for clients or on its own account. Gaohua's application for a brokerage license then took two years to be approved; it was finally approved at the State Council level, said Yin. Yin noted that details of how it structured the deal were still sensitive and

not to be discussed with the press.

¶3. (SBU) Further emphasizing Gaohua's uniqueness, Yin told the story of the China Securities Regulatory Commission Chairman Shang Fulin response to Merrill Lynch's request for similar treatment. Shang apparently said, "You know how China has a one child policy? Gaohua is an only child." Goldman has successfully built its brand here so that, in Chinese, Gaohua means Goldman Sachs.

¶4. (SBU) Yin said that while the loans to the two Chinese individuals were unsecured, they were treated as Goldman partners and received remuneration in the form of Goldman stock. This had the effect of tying them closely to Goldman's financial performance and provided a quasi-guarantee for the loan.

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Subtle Barriers to Securities Business in China
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¶5. (SBU) Yin said that in addition to explict barriers to FDI in financial services in China, there were also many "subtle barriers" for foreign companies. To be certified as a "senior manager" in a securities business, one needed to take the "Senior Manager Exam." This exam was only offered in Mandarin Chinese. Yin said that to pass this exam one needed to have been educated in Chinese as it was highly technical. Yan, an American citizen and 14-year Goldman partner, admitted that although he had been born in China and was a native Chinese speaker, he had to take the exam twice. Once the examination was passed, the senior manager then needed to have all original diplomas certified by a special office in Beijing. Finally, the applicant for a senior manager position must then provide the passport numbers and names of all of his extended family members



-- including uncles, aunts, and cousins. This final measure was to allow the Chinese government to stop these people from fleeing China in case of fraud investigations. Yin said, however, it made him feel like he was already being treated like a criminal. Because his diplomas had yet to be certified, Yin had to use the title "Executive Director" rather than "General Manager."

¶6. (SBU) In addition to the senior management test, 75 percent of all personnel at a securities firm must be citizens of the People's Republic of China. This combined with the Chinese language requirements for senior managers created a difficult but not insurmountable challenge for overseas firms, said Yin.

¶7. (SBU) Another barrier, said Yin, was the licensing requirement to become an "innovative broker." This license allowed securities firms to create financial products. To qualify, a brokerage submitted an application to an industry panel, "made up of your competitors," said Yin. This panel was then, "invited into a firm's back room, to view all of its internal processes, and kick the tires," he added.

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Gaohua: A Chinese Firm with Foreign Limitations
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¶8. (SBU) While Gaohua had been granted a full brokerage license, and was technically a wholly-owned Chinese securities company, it continued to face extra scrutiny and controls from the CSRC, said Yin. He noted that Gaohua's underwriting of the Ping An Insurance's initial public offering (IPO) had received a great deal of media attention. When Gaohua subsequently sought approval to underwrite another, Yin said, the CSRC indicated that Gaohua had had "too much publicity" and then refused permission to underwrite the next IPO.

¶9. (SBU) Yin speculated that foreign fund management firms and had been more welcomed in China than foreign securities firms since the former was a relatively new industry in China and

foreign firms offered technology and know-how that China lacked. Securities firms, on the other hand, had been established longer in China and due to financial weakness more reluctant to face foreign competition. Yin said that Chinese authorities did not appear interested in following the "London Model" of opening up their securities industry which had lead to a vibrant financial center at the expense of domestically owned firms, but would pursue a more gradual and restrictive approach that would leave a larger role for domestic securities companies.

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Safety in Numbers
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¶10. (SBU) Yin was clearly pleased with the leadership position that Goldman Sachs had taken in China. However, he also admitted that being the only "foreign" securities firm in China also had its downsides. He said that currently Goldman was "the only voice" and that it was forced to break all new ground on its own. When more foreign securities firms were allowed to do business in China, Goldman would be able to benefit from having "a collective voice" to share its concerns. For the meantime, Yin said, Goldman was attempting to set a good example of the benefits that foreign firms could bring to China and act as a good corporate citizen. It had spent a great deal of effort and time training and advising the CSRC. "We treat them like a client," he said.
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